IN THE HIGH COURT OF JUDICATURE AT MADRAS

Dated : 23.1.2007

Coram

The Honourable Mr.Justice P.D.DINAKARAN

and

The Honourable Mrs.Justice CHITRA VENKATARAMAN

T.C.(Appeal)No.125 of 2003

Commissioner of Income Tax
Coimbatore ...Appellant

-vs-

M/s.Venkatesa Spinners Pvt. Ltd
Coimbatore ...Respondent

Tax Case (Appeal) is against the order of the Income Tax Appellate Tribunal Madras A bench, dated 7.3.2003 in ITA.No. 2161/Mds/94 for the Assessment year 1991-92. against the order of the Commissioner of Income Tax (Appeals) Coimbatore dated 29.7.1994 in ITA.No.298-C/94-95 against the order of the Deputy Commissioner of Income Tax, special Range I, Coimbatore dated 17.3.94 in PAN/GIR.No.CN.1038/SR.I/CBE,for the Assessment year 1991-1992.

For Appellant : Mr.Murali Kumaran,
SCGSC

For Respondent : Mr.Vijayaraghavan for
M/s.Subharaya Aiyar

JUDGMENT

(The judgment of the Court was delivered by CHITRA VENKATARAMAN,J)

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This appeal is at the instance of the Commissioner of Income Tax, Coimbatore. The assessment year under consideration is 1991-92. The question of law raised in the appeal is whether the Assessing Officer has the power to reject the change in the method of valuation of closing stock adopted by the assessee. There is no quarrel about the settled position of law that the Assessing Authority has the power to reject the change in the method of valuation of closing stock when change itself is not genuine and

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bona fide. It is an accepted principle of law that under Section 145, first proviso to sub section (1), that even in cases where the accounts are correct and complete to the satisfaction of the Assessing Officer, in cases where the income could not be properly deduced therefrom, then it is open to the Assessing Officer to compute the income in such a manner as he may determine. The crux of the provisions under Section 145 is that even if the Assessing Officer accepts the assessee's method of accounting, he is not bound by the results flowing from the accounts. The Act enjoins a duty on the Assessing Officer to consider whether the income on profits and gains can be properly deduced there from. The Authority for this proposition can be seen from the decision of the Supreme Court reported in 33 ITR 182 (CIT v. MACMILLAN AND CO.,).

2. As regards the valuation of closing, it is a settled law that an assessee is entitled to value the closing stock either on stock price or market price which ever is lower. In the decision reported in 44 ITR 22 (INDO COMMERCIAL BANK v CIT,) this Court took the view that the fact that the option exercised by an assessee is detrimental to revenue could never be the basis for denying him that option. Summarising the principle on the question of valuation of stock, in the decision reported in 188 ITR 44 (CIT v. BRITISH PAINTS INDIA LTD), the Apex Court held that.

> "The correct principle of accounting is to enter the stock in the books of account at cost unless the value is required to be reduced by reason of the fall in the market value of those goods below their original cost. Ordinarily, therefore, the goods should not be written down below the cost price except where there is an actual or anticipated loss. On the other hand, if the fall in the price is only such as it would reduce merely the prospective profit, there would be no justification to discard the initial valuation at cost. ...."

2. The Apex Court further held that,

> "Section 145 of the Income tax Act, 1961, confers sufficient power upon the officer – nay it imposes a duty upon him- to make such computation in such manner as he determines for deducing the correct profits and gains. This means that where accounts are prepared without disclosing the real cost of the stock-in-trade, albeit on sound expert advice in the interest of efficient administration of the company, it is the duty of the Income-tax Officer to determine the taxable income by making such computation as he thinks fit. "

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3. Placing reliance on this decision, the learned counsel for the Revenue submits that considering the provisions of Section 145, it is only the Assessing Authority who has the right to change the system of valuation and that an Assessing Authority can ignore the method of valuation adopted by the assessee to arrive at the proper income. The sum and substance of the submission made by the learned counsel for the Revenue is that the assessee has absolutely no option to change his method of accounting. He placed reliance on 188 ITR 44 at page 56 and submits that the assessment made by the officer is correct. He also submitted that the change in the system of valuation adopted by the assessee lacked bonafides. In the circumstances, he submits that the order of the Tribunal merits reversal.

4. We do not agree with the contention of the learned standing counsel for the Revenue. A perusal of the decision of the Supreme Court reported in 188 ITR 44, clearly shows that the well recognised principle of commercial accounting as regards the valuation of closing stock is cost price or market price, whichever is lower. Section 145 enjoins an assessee to follow a regular method of accounting, so that profits and gains of business or profession or income from other sources could be computed in accordance with the accounting method regularly employed by the assessee.

5. In a decision reported in 255 ITR 351 (CIT v PUNJAB STATE INDUSTRIAL DEV. CORPN.), the Punjab and Haryana High Court interpreting the word 'regular', held that the provisions cannot be interpreted to mean that once a system of accounting is adopted, it can never be changed. 'Regular' cannot in the present context mean permanent.

6. In a decision reported in 279 ITR 434 (SANJEEV WOOLEN MILLS v. CIT), the Apex Court held that the Revenue is bound by the assessee's choice of method regularly employed. The method of accounting followed by the assessee cannot be substituted by the Assessing Officer merely because it is unsatisfactory. What is material for the purpose of Section 145 of the Income Tax Act, 1961 is that the method should be such as to enable a real income, profits and gains to be properly deduced therefrom. Speaking on the method of valuation on closing stock, in the decision reported in 250 ITR 871 (SAKTHI TRADING CO. v. CIT), the Apex Court held that,

> '...But on no principle can one justify the valuation of the closing stock at a market value higher than the cost as that will result in the taxation of notional profits which the assessee has not realised....."

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7. In the reported case, the assessee followed the valuation of closing stock at the market value irrespective of the fact whether the market value of the stock at the relevant time was more than the cost value of the stock, which necessarily resulted in imaginary or notional profits to the assessee which he had not actually received. The Apex Court further held that,

> ".....It is a well settled principle as held in SIR KIKABHAI PREMCHAND v. CIT (1953) 24 ITR 506 (SC) the Constitution Bench judgment that the firm cannot make a profit out of itself. The transaction which is not business transaction and does not derive immediate pecuniary gain is not subjected to tax. In the present case showing the market value of the closing stock the assessee has earned potential profit out of itself in as much as the stock-in-trade remained with the assessee at the closing of the accounting year. Secondly, putting the stock at the market value does not and cannot bring in any real profit which is necessary for taxing the income under the Act as is held in CHAINRUP SAMPATRAM v. CIT (1953) 24 ITR 481 (SC) AND CIT v. HIND CONSTRUCTION LTD (1972) 83 ITR 211 (SC). Thirdly, it is a settled principle of income-tax law that it is the real income, which is taxable under the Act. This proposition was enunciated in CIT v. BIRLA GWALIOR (P) LTD (1973) 89 ITR 266 (SC), which was pronounced in CIT v. SHOORJI VALLABHDAS AND CO. (1962) 46 ITR 144 (SC)".

8. In the circumstances, the Apex Court held that if the method employed by the assessee did not enable the Assessing Authority to deduce the correct chargeable income, the Assessing Authority could apply different methods of accounting to deduce the income chargeable. As far as the valuation of closing stock is concerned, the recognized and settled legal position is that the closing stock has to be valued r at market value or cost value, whichever is low.

9. In the light of the settled principle of law and having regard to the fact that the term 'regular' cannot mean a permanent pattern of accounting working, the learned counsel for the assessee submits that the method adopted by the assessee reflected the true income, and as such, the Revenue is not entitled to reject the method of accounting alleging that it lacked bona fides. The learned counsel referred to a letter submitted before the Officer, which is extracted at page 2 of the paper book containing the assessment

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order. The reply stated that they had switched over the valuation from market value to the cost price which had been recommended by the Institute of Chartered Accountants of India. They also placed reliance on the decision reported in 149 ITR 759 (CIT v. CARBORANDUM UNIVERSAL LTD). A perusal of the decision shows that so long as the method of valuation adopted by the assessee gets recognition from the practising accountants and the commercial world for valuation of stock-in-trade, the adoption of that method cannot be questioned by the Revenue unless the change is found to be not bona fide or restricted for a particular year.

10. The learned counsel for the assessee submits that the Assessing Authority's view that the change over of method of valuation did not reflect true affairs of the profits of the assessee is not correct. The method adopted by the assessee is on the line of the established accounting principles which are approved by the decisions of the Apex Court. The learned counsel for the Revenue pleaded for a remand to enable the Assessing Authority to give a finding on the question of bona fides. It must be noted that the valuation at cost price or market price whichever is lower is an accepted method of valuation of closing stock. The decisions, which were relied on by the assessee as well as by the Revenue, outline the principles given by the Apex Court as to the valuation. The only difference in the presentation of the argument between the parties herein is that while the Revenue contends that the system adopted by the assessee lacked bona fide, the assessee countered it by saying that following the well recognised system of accounting could not be stamped as lacking in bona fide. So long as the system followed by the accounting standards reflect the true profits of the business, the Revenue cannot reject the method as lacking in bona fide. A perusal of the order of the Assessing Officer indicates that such line of reasoning does not indicate that the method adopted did not reveal true profits of business. Placing reliance on 188 ITR 44 the Assessing Authority stated that even if the assessee had adopted a regular system of accounting, it was the duty of the Assessing Officer under Section 145 of the Income Tax Act, 1961 to consider whether the correct profits and gains could be deduced from the accounts and if the Officer feels that true profits could not be deduced from the accounts, he had the right to take recourse to the proviso to Section 145 of the Income Tax Act, 1961. Having thus correctly understood the decision, the Assessing Officer had immediately jumped to the conclusion without any enquiry, that it was not possible to accept the change over as it had not reflected the true state of affairs of the profits of the company. As already stated,while the decision of the Apex Court recognised the authority of the Assessing Authority to reject the accounts under the stated circumstance, at the same time, the Apex Court held that the method of valuation of closing stock needs to be based on market value or cost price which ever is lower. In the absence of any such exercise,

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mere rejection ipso facto does not support the case of the Revenue. In the absence of any such finding, we do not find any justification to go against or reject the accounts.

11. In the decision reported in 202 ITR 789 (MELMOULD CORPORATION v. CIT), the Bombay High Court at page 792 referred to the booklet called "Valuation of stock and work-in-progress-normally accepted accounting principles" brought out by Indian Merchants' Chamber Economic Research and Training Foundation, which may usefully be extracted here too,

> "2. Where a change from one valid basis to another valid basis is accepted, certain consequences normally follow. The opening stcok of the base year of change is valued on the same basis as the closing stock. Whether the change is to a higher level or to a lower level, the Revenue normally does not seek to revise the valuation of earlier years. It neither seeks to raise additional assessments, nor does it admit relief under the 'error or mistake' provisions.
>
> 3. It is not possible to define with precision what amounts to a change of basis. It is a convenience, both to the tax payer and to the Revenue, not to regard every change in the method of valuation as a change of basis. In particular, the Revenue encourages the view that change which involves no more than a greater degree of accuracy, or a refinement, should not be treated as a change of basis, whether the change results in a higher or a lower valuation. In such cases the new valuation is applied at the end of the year without amendment of the opening valuation' (underlining* ours)"

12. Given the recognition as to the accepted accounting principles, and which have been followed by the assessee herein on the same lines, we do not find any justification to accept the plea of the Revenue. In the circumstances, the appeal has to be dismissed.

13. As already extracted, the question of law herein is whether the Officer has right to reject the valuation method of closing stock, if it is not based on genuine reasons. It must be noted that irrespective of a change in the method of accounting/valuation, the Act enjoins a duty on the Assessing Authority to get into accounts to deduce what would be the correct and true profit and gains from the business. Whatever be the method of accounting, it is the duty of the Assessing Officer to consider whether the income, profits and

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gains can be properly deduced from the method adopted by the assessee and if not and to compute the same accordingly.

14. Considering the scope of the power available under Section 145 of the Income Tax Act, in the absence of any finding that the change is not for any genuine reason and considering the fact that valuation itself is based on accepted principle of accountancy as well recognised in several decisions of the Apex court and this Court, we do not find any reason to disturb the order of the Tribunal.

15. The question itself seems to have been framed with an academic flavour. Consequently, the appeal is rejected. No costs.

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Sd/
Asst.Registrar

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Sub Asst.Registrar

To

1. The Assistant Registrar,
Income Tax Appellate Tribunal,
Rajaji Bhavan, III Floor,
Besant Nagar, Chennai-90

2.The Commissioner of Income-Tax,
Coimbatore.

3.The Commissioner of Income-Tax (Appeals),
Coimbatore.

4. The Deputy Commissioner of Income Tax,
Special Range I, Coimbatore.

+ 1 cc to Mr. N. Muralikumaran, Sr Standing Counsel for Income Tax, SR no. 4743

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